Speech by Rolf Skog given at the Legalink ESG seminar in Stockholm June 6, 2024.

The Long and Winding Road to the Corporate Sustainability Due Diligence Directive

Thank you for inviting me. When my old friend Paulo asked me not only to give a talk on the EU Directive on Corporate Sustainability Due Diligence from a corporate governance point of view but to do this in Stockholm, on Sweden´s National Day, I just couldn´t resist.

From the programme you can tell that I have academic affiliations but since I also serve as a company law expert to the Swedish Ministry of Justice, I must give the standard disclaimer that my remarks are my own and do not necessarily represent the views of the Ministry or its staff.

Introduction

Two weeks ago, on 23 May, the Council of the European Union voted in favour of, and thereby de facto adopted, the Corporate Sustainability Due Diligence Directive. The aim of this Directive is, "to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance." To achieve this, the Directive establishes a corporate due diligence duty the

core elements of which are: *identifying*, *bringing to an end*, *preventing*, *mitigating* and *accounting* for negative human rights and environmental impacts in the company's own operations and its chains of activities.

The Directive is well embedded in European Union policies, declarations and ambitions in the field of human rights and environment. In the approx. 200 pages preamble to the Directive there are references to the Green Deal and a myriad of other EUdes. measures as well as to UN Principles, OECD guidelines etc. adopted over the last couple of decades.

The history of the Directive is, however, anything but straightforward. Let me remind you here today of the, not so smooth, genesis of the Directive or, to paraphrase Lennon/McCartney "the long and winding road" to the Directive, with a special focus on the – supposed to be – corporate governance provisions of the Directive.

The Proposal for the Directive

Building on the EU Commission Action plan of 2018 on Financing Sustainable Growth, the Commission, in the Spring of 2020, published two studies that were to be pillars of the later Proposed Directive. The first one was a study on Due Diligence requirements through company supply chains. The other study, entitled Directors´ Duties and Sustainable Corporate Governance, focused on "*assessing the root causes of short termism in corporate governance*".

The Commission posted the studies on its website asking for “initial feedback” and the responses did not delay. Views poured in, especially on the latter study, from industry, from investors, from academia, from NGOs as well as from Member States. Not all, but many commentators delivered, politely speaking, humiliating criticism. The bottom line was that the study on Directors´ Duties and Sustainable Corporate Governance was founded on erroneous assumptions regarding the functioning of the economy, did not meet even elementary requirements for scientific method and, in several respects, was substantially biased.

In the view of the critics the Commission should reconsider the matter. This was not, however, the conclusion of the Commission. On the contrary, the Commission moved along as though nothing much had happened and in October 2020 launched a formal “public consultation” - based on the results of the studies.

Not unexpectedly, the criticism remained and, this time around, the Commission was also criticised for having ignored the grave condemnation of the corporate governance study. Still, the Commission gave notice that a formal directive-proposal on Sustainable Corporate Governance would be presented in the Spring of 2021.

This was not the case, however. Like other proposals for directives presented by the EU Commission, this initiative was to be reviewed by the Commission's own quality control, the Regulatory

Scrutiny Board. No proposed directive may be presented by the Commission without the go-ahead from the Scrutiny Board. Normally, this is a straightforward, internal process that outsiders rarely learn about. This time, however, the situation was different. At its meeting regarding the planned proposed directive in early May 2021, the Scrutiny Board rendered an overall negative opinion and observed that the draft proposal and the impact assessment were associated with significant shortcomings. Hence, the draft got a red card!

As a direct consequence, the Commission amended the timetable for the proposal and set a new date for its publication: the Fall of 2021. History, however, repeated itself. When examining a revised draft, the Scrutiny Board once again raised the red card.

According to the Scrutiny Board the Commission still failed to clarify "*the need to regulate directors' duties on top of due diligence requirements"*.

Now there would only be one more chance. Following a third failed attempt, the proposal would have to be withdrawn. Something radical had to be done. Hence, widening the responsibility for the directive within the Commission and taking aboard more seriously the Scrutiny Board criticism the proposal for a directive on "Sustainable Corporate Governance" was morphed into the proposal for a Directive on "Corporate Sustainability Due Diligence" that was put on the table in February 2022.

The Proposal largely built on the first of the two initial expert reports – the report on due diligence requirements through company supply chains. Still, however, there were corporate governance requirements in the proposal that could easily be traced back to the second report – the corporate governance study. And, *nota bene*, the invoked legal basis in the Treaty (Art 50 and Art 114) were the very same as for the company law directives.

Despite the overwhelming opposition expressed in the public consultation in 2020, the Commission insisted on keeping some highly controversial corporate governance parts in the Proposal by referring to '*the political importance*' and '*the urgency of action*', arguments without any substantive underpinnings.

The inclusion of these already refuted ideas not only tainted the Proposal, but also had the consequence of mixing what should be a purely external relationship (the legal obligations of due diligence concerning the company's conduct) with the internal structures for governance and the company's decision-making process.

The most relevant corporate governance related provisions were Article 25 on director's duties and Article 26 on responsibility of the due diligence actions required.

I do not in any way dispute the Commission's right to promote any political goal as it is empowered to do according to the founding treaties, but I find it troublesome that the Commission this time failed to clearly signal the far-reaching intention to harmonise

corporate governance, especially when that ambition had been met with considerable opposition. To ignore this opposition questioned the value of public consultations and to embed such provisions in a directive on due diligence is, in my view, contrary to the principles of better regulation that the Commission is obliged to observe.

The Commission argued that the provisions on directors' duties were justified because the company's compliance with due diligence necessitates a regulation of management responsibilities and duties and that the provisions harmonising corporate governance is linked to that due diligence. I found it hard to see how this was correct.

Considering the proposed *Art. 25*, on directors' duty of care, it imposed a general requirement that the company directors', *"when fulfilling their duty to act in the best interest of the company […] take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.*" In the view of many critics, none of these had any obvious relevance to due diligence.

The proposed *Article 26* required the directors of companies covered by the Directive to be responsible for putting in place and overseeing the stipulated due diligence obligations. This was, however, entirely superfluous, because once such obligations have been imposed on the firm, it automatically follows from national company law that the board (and management) is equally

obliged; after all, the board and the management are the embodiment of the company and bears the ultimate responsibility for all company obligations, be that in the field of environment, labour, taxes or whatever.

Hence, despite the fierce criticism of the Commission's original initiative on so-called 'sustainable corporate governance' by a large number of company law experts in the EU (and, incidentally, also the US) these elements were reused by the Commission in the formal Directive Proposal presented to the Council and the European Parliament.

Given this, allow me to recall that the key reason for the criticism was that the grounds for the initiative presented in the *Study on Directors' Duties and Sustainable Corporate Governance* in 2020, could not be substantiated by empirical evidence, and many if not all of the conclusions in the study either appeared to be very poorly substantiated or plainly wrong.

In its original initiative the Commission, at the outset, recognised that Member States' national company law requires the management of companies to show due care for the lawful and sound management of the company, including taking into account all foreseeable risks to the company, and among them the risks related to the environment and climate change. Indeed, it is impossible to dispute this fact, which can be easily ascertained by consulting national law. Quite surprisingly, however, it was contended that company directors choose to set aside these clear obligations under national law in order to accommodate the short-

term desire of shareholders for maximum distributions and buy backs of shares, which depletes the companies of capital needed for the green transition. In the light of this contention, it was concluded that, in the interests of the green transition and sustainability, it is necessary to harmonise the duties of corporate governance, where it must be ensured that directors have a duty to act 'sustainably' and where shareholders must be removed as far as possible from influence over management, which must instead be monitored by a more indefinite circle called the company's 'stakeholders'.

The problem, of course, was that the second contention, that company directors choose to set aside their obligations under national law in order to accommodate the short-term desire of shareholders, was wrong. In reality, shareholders and equity financing drive the green transition and demand that company boards and management consider climate risks, because the shareholders as investors are interested in companies´ long-term results, which is decisive for the present-day value of their shares and the prospective return on their investment.

The consequence of the fact that the negative effects that the Commissioned pointed out with “shareholderism” could not be substantiated was decisive because the chain of arguments then collapsed. It was for this reason that the Regulatory Scrutiny Board did not just once but twice overruled the Commission's initiative – the Commission had failed to establish the need for EU legislation in this area. The Commission did not succeed in doing this and it was therefore, in my view, disheartening to see that the same

arguments were put forward again in the Proposal. It was as if the public consultation in 2020 never took place.

In short, the wish for harmonisation of directors' duties is a remedy for a problem that has not been proven to exist. To put it differently, articles 25 and 26 were unnecessary in relation to due diligence.

The negotiations

The proposed directive, including articles 25 and 26, was delivered to the European Parliament and the Council, respectively, for deliberations. The Commission was of course eager for the Council to make quick progress. That, however, turned out not be the case. For most Member States regulating Corporate Sustainability Due Diligence was an expedition in unchartered territory where there were no obvious roads to take. Furthermore, in most Members states the issues covered by the proposed Directive involved not just one but several ministries. This, of course, typically makes it hard to quickly form national positions.

In the Council (Working Party) the negotiations on the Proposed Directive began during the French Presidency in January 2022. While the Presidency, as always is the case, started out with high ambitions, it soon became clear that to most MS lots and lots of questions would need to be answered, lots of vagueness would need to be removed and many concessions would need to be made before the Council would be ready to agree on a so called general approach. Furthermore, many Member states already at

the very first meeting argued that the corporate governance related provisions, notably 25 and 26, should be deleted. In this respect, the message from the Member States was crystal clear.

All in all, not much progress was made during the French presidency period. The Czech Presidency managed, however, to speed up the process. Several Presidency compromise proposals were put on the table until, to the surprise of many, Member States on 1 December 2022 were able to agree on a general approach, where, *nota bene*, the corporate governance related articles 25 and 26 were deleted.

Next in the Council Presidency seat – from 1 January 2023 – was Sweden. With the deliberations in the Council being finished our occupation with the Directive proposal was, however, limited. For the first three, four months we basically just waited for the outcome of the reading in the European Parliament – a complex process led by the JURI Committee and the rapporteur Lara Wolters.

In late April 2023 the JURI Committee adopted its report. Lots of compromises had been made in relation to the Council position but the corporate governance articles 25 and 26 remained unchanged. This was not the last word, however. MEPs were split in different political camps and in the final plenary vote that took place on 1 June 2023 a request was made for a formal counting of the votes in relation to articles 25 and 26 with the result that article 26 was not approved while article 25, probably by mistake, was approved. With such a weak mandate it was very likely that in the upcoming trialogues involving the Council, the Parliament and the

Commission the corporate governance provisions in the Directive would finally have to go.

This was also exactly what happened. When the Directive was finally approved, after almost a year of intense tripartite negotiations and political horse trading – only 17 MS voted in favour – there was a hole where there once were provisions tilting directors´ duties in the direction of stakeholderism.

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From a company law and corporate governance perspective this was, in my view, a very important and good outcome of the negotiations.

Does this mean that I do not believe that steps must be taken to correct inhumane working conditions, to curb climate change and solve other problems facing the world? Not at all. The question is what means are suitable to reach these goals.

In Sweden, as in most other European countries, living conditions have continuously improved since the breakthrough of industrialism. Progress has been enormous in many areas, including the environment. How has this progress been achieved? Well, by virtue of the fact that society, within the context of the political system, has enacted legislation and other forms of rules which establish the framework for the activities of companies as well as through taxes and fees on various types of the negative external effects of businesses. Never ever did we

contemplate tackling “ESG issues” by amending the provisions on directors´ duties (or any other provisions) in the Companies Act.

Underscoring this fact may seem trivial, but in a political democracy it is through the political system that we balance various interests in such a way that the result reflects the preferences of the citizens, not the preferences of business leaders at any given time.

Trade-offs on social/political issues, including allocating capital to determine environmental/health/safety/consumer protection-standards can only be made by those accountable through a very different kind of market test – the political process. Who do we want to trust to establish auto safety and emission standards – the auto industry or the regulator?

Another wholly pivotal objection to a statutory regime in which, for example, the board is obliged – call it “in the interest of the company” or call it in the interest of something else – to pit the interests of various stakeholders against one another (that is, to simultaneously strive towards several goals) is that such a regime would make it impossible to evaluate the board or the management. With a multi-dimensional purpose, the board would always be able to claim that poor performance relative to certain targets was due to the fact that the board gave priority to one or more other goals. It’s like a shell game in the streets where the pea is always under the shell you didn’t pick.

In short, accountability to everyone is accountability to no one. As Adolph Berle, one of the most cited scholars in the field of corporate

governance ever, wrote as early as in 1932: “You cannot abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their shareholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.”

There is good cause to let the politicians take responsibility for what is termed “sustainable” development by continuing to establish the limits on the activities of companies. Not by redefining the duties of directors (or the purpose of the company).

This, of course, requires an effective government, and we all know well-functioning polity is not to be found everywhere today. This is a very serious problem, but - as so elegantly stated in an editorial in *The Economist* some time ago – “empowering the bosses of big businesses to act as an expedient substitute is not the answer”.

Let me finish with a few words on the significance of the profit purpose for economic growth and welfare. One of the most well-established economic relationships is the link between capital formation, productivity and economic growth. History has taught us that the ability of companies and industry to continuously invest in new and better production methods is critical to the possibility of improving the living conditions of citizens, and that capital markets are central to this process.

Today, stock markets and the supply of risk capital is global. During the last two decades Europe’s share of the global stock market value of non-financial companies has fallen by nearly 50

per cent, while the dominance of the US and China has grown. The total stock market value of all European listed companies today equals only 10 per cent of the global market value. The combined market value of the 30 largest German listed companies (DAX30) does not rise even to the level of two-thirds of the value of Apple alone.

The EU Commission have, correctly, expressed concern for the lack of efficient supply of risk capital in Europe and initiating several reforms aiming at deepening the Capital Markets Union. This does not bode well with ESG-linked ideas about redefining directors´ duties or the purpose of the company in the direction of different stakeholders´ interests. Such reforms would create increased uncertainty amongst investors as regards the condition governing the contribution of risk capital to European companies and thereby create a substantial risk that European companies will experience a reduction in their access to risk capital, that business-sector dynamism and innovation will be hampered, and that the incentives undertaking forward-looking investments and innovations necessary to support sustainable economic growth will be undermined. In other words, that the European business sector will continue to fall behind the rest of the world.

Thank you for your attention.